IN THE

Supreme Court of The United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,
Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF PENNZOIL PRODUCING COMPANY

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INDEX

CITATIONS

Cases

Statutes

FERC Opinions

Regulations

Other

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OPINIONS BELOW AND JURISDICTION

The opinions below are correctly referenced and the jurisdictional prerequisites are adequately set forth in the brief of the Federal Energy Regulatory Commission (Commission).

QUESTIONS PRESENTED

1. Whether the Commission has the authority to consider and permit a natural gas company to collect a rate in excess of Commission established ceiling rates to allow recovery of a prudently incurred increased royalty cost?[1]

2. As will be discussed *infra*, Pennzoil Producing Company (Pennzoil) is unsure what question with respect to abandonment authorization under Section 7(b) of the Natural Gas Act[2] should be briefed. In its petition for certiorari, the Commission framed the question as one of authority to permit abandonment, and certiorari presumably was granted with respect to that issue. However, in its brief the Commission states the issue and argues it as a question of whether the Commission's decision regarding abandonment was correct on the merits.

STATUTES INVOLVED

The Commission's brief properly references the statutes involved.

STATEMENT

This case presents to this Court for the first time in the context of an actual controversy the question of the regulatory treatment to be accorded royalty costs incurred in connection with gas produced under "market value" royalty leases and sold subject to the jurisdiction of the Commission. The Commission's position is that it has no authority to respond to the regulatory problems created by market value royalty costs and therefore it cannot allow recovery of

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[1] As we will demonstrate in the Statement portion of this brief, the Commission is factually wrong in asserting that Pennzoil's proposed rate increase is based on the "unregulated price of natural gas in the intrastate market" (Comm. Br. 2, 14, 26-27). The incremental royalty rate is based solely on a percentage of Commission established rates.

[2] 15 U.S.C. § 717f(b).

such costs. Pennzoil believes the Commission has unduly and unjustifiably restricted its authority to the detriment of both the natural gas companies it regulates and the consumers whose interests it is charged with protecting.

The facts are undisputed. Pennzoil sells to United Gas Pipe Line Company (United) gas produced from acreage leased in Louisiana from Williams, Inc., *et al.* (Williams) (A. 41-42). Because the sale is in interstate commerce for resale it is subject to the Commission's jurisdiction and the price which Pennzoil may collect is limited to the applicable ceiling prices established by the Commission. These ceiling rates apply to the royalty share of the gas as well as Pennzoil's working interest share. At the same time, however, the amount that Williams as lessor receives from Pennzoil for the sale of the royalty share is not subject to Commission jurisdiction. *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972).

The Williams lease provides for royalty payments based on one-eighth of the "market rate" of the gas (A. 133). Pennzoil is collecting the highest rates allowed by the Commission for Williams acreage gas (A. 42), an average of about 40.9¢ per Mcf at the time of the hearing in this case (A. 158), and is paying royalty based on such rates.[3]

Williams claims, however, that the "market rate" for the gas is in excess of that which the Commission has determined to be the highest rate which Pennzoil can collect. Williams' claim as to the "market rate" has steadily escalated from 70¢ per Mcf for the period November 1973 through May 1974, to $1.40 per Mcf for the period January 1975 through April 1975 (A. 114; 120; 423). These claims

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[3] A portion of the gas is covered by the national rate set forth in 18 C.F.R. § 2.56b, and the rest is covered by the national rate set forth in 18 C.F.R. § 2.56a.

have been asserted by Williams in a lawsuit currently pending in a Louisiana state court.[4]

The prices upon which Williams claims royalties should be based are far in excess of the applicable ceiling rates which Pennzoil is actually collecting. Relying on cases such as *J. M. Huber Corp.* v. *Denman*, 367 F.2d 104 (5th Cir. 1966), and *Texas Oil & Gas Corp.* v. *Vela*, 429 S.W.2d 866 (Tex. 1968), Williams asserts that the basis for royalty payments under the market value royalty provision is not limited to the price actually being collected. In addition, relying on the *Mobil* determination that the Commission has no jurisdiction over royalty owners, Williams asserts that the Commission's ceiling rate does not limit the price upon which royalty payments are to be based. Williams' claim is for damages in excess of $3,000,000 for alleged past underpayment of royalties through April 30, 1975, and lease termination on the basis of the alleged underpayment of royalties. In addition, Williams seeks a declaration that future royalties must be based on the prices alleged by Williams to represent market value in the event the lease is not terminated (A. 120).

The parties to the state court litigation have reached an agreement which, if implemented, would resolve that litigation.[5] Implementation of the settlement is dependent upon Commission authorization of one of two alternatives set forth in the agreement, however. Under the first alternative, Pennzoil would increase the basis upon which royalties

[4] *Shell Oil Co. and Pennzoil Producing Co.* v. *Williams, Inc., et al.*, Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591 (A. 4).

[5] As to footnote 4 in the Commission's brief, Pennzoil has seen no evidence to suggest that "market value" royalty clauses are "fairly common," and the Commission cites none. Also, we believe the most that can legitimately be said with respect to the Supreme Court of Louisiana's view on such clauses is that such view, if any, is unknown. *Whitehall Oil Co.* v. *Boagni*, 229 So.2d 702 (La. 1969), cited by the Commission, certainly intimates no such view.

are paid to an amount specified in the agreement contingent upon Commission authorization allowing recovery of the resulting increased royalty costs in the price Pennzoil charges United for the gas. Under the second alternative, the litigation would be settled if the Commission authorized Pennzoil to abandon the sale of the royalty share of the gas so that Williams could take its royalty share in kind.

By its application below, filed under Section 4 of the Gas Act,[6] Pennzoil sought the requisite Commission authorization. Because the price increase is totally based on increased royalty costs and will therefore generate absolutely no profit for Pennzoil, and because this cost is a prudent and necessary expense, Pennzoil believes the price increase to be just and reasonable.

The Commission, however, rejected the price increase request. The Commission first determined the test to be whether "... this *incremental royalty* cost is just and reasonable" (A. 260, emphasis by Comm.).[7] Pennzoil agreed with the Commission that it had properly stated the test, and no party challenged that test on appeal. However, having stated the test to be applied in reviewing Pennzoil's application on the merits, the Commission ignored that test and the record evidence relating to it, and denied relief on the sole ground that, regardless of the facts or consequences, it lacks statutory authority to permit gas producers to collect rates in excess of Commission set ceilings in order to recover incremental royalty costs occasioned either by settlement of market value royalty claims or court order directing payment of such claims. Indeed, the Commission held that it lacked authority to permit collection of any incremental royalty cost "based on other factors than the regulated rate" (A. 260), relying on *FPC* v. *Texaco Inc.*,

[6] 15 U.S.C. § 717c.

[7] The Commission's counsel erroneously implies that it did not thereby implicitly reject the different test on the merits applied by the administrative law judge (Comm. Br. 34).

417 U.S. 380 (1974). On rehearing, the Commission stated that facts showing the proposed rate to be just and reasonable in accordance with Section 4 of the Gas Act "are not controlling. The Commission does not have the power to base a part of the regulated price on the unregulated market value of intrastate gas" (A. 293).

With respect to abandonment, the Commission once again ignored the evidence showing that abandonment of the royalty interest gas would be in accord with the statutory test applicable to abandonment,[8] and denied abandonment on the ground that under its *Southland*[9] decision the gas would remain subject to its jurisdiction even if the lease was terminated and, therefore, the non-existent risk of loss of gas to the interstate market did not justify abandonment (A. 262-63).

The court of appeals reversed on both points (Pet. App. 1a-9a). As to the rate issue, the court held that the Commission has authority to permit a rate increase reflecting incremental royalty costs based on settlement of market value royalty claims and that Pennzoil and Shell Oil are "entitled to a determination of the merits of their requests" (Pet. App. 8a). Noting its reversal of the Commission's *Southland* opinion,[10] the court reversed and remanded the Commission's denial of abandonment authorization (Pet. App. 2a, 8a-9a).

The Commission erroneously represents and implies to the Court that the incremental royalty cost underlying Pennzoil's request for rate relief is "based on the unregu-

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[8] *I.e.*, whether "the present or future public convenience or necessity permit such abandonment." 15 U.S.C. § 717f(b).

[9] *El Paso Natural Gas Co.* 54 FPC 145 (1975), subsequently *aff'd sub nom. California* v. *Southland Royalty Co.*, U.S. (1978).

[10] *Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5th Cir. 1976), *rev'd sub nom. California* v. *Southland Royalty Co.*, U.S. (1978).

lated price of natural gas in the intrastate market" (Comm. Br. 2, 12, 13, 14, 15, 16, 17, 19, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 32). As can be seen from the settlement agreement, the royalty is directly tied to the Commission's own rates (A. 17-18). Basically, the settlement agreement calls for royalty to be based on the higher of 78¢ per Mcf or 150% of the highest Commission set area or national rate. On October 24, 1977, Pennzoil's lessors agreed, effective July 26, 1976, (the date of the Commission's latest national rate opinion[11]) that the royalty would be 100% rather than 150% of the Commission set area or national rate.[12] The 150% figure was agreed upon because it was the figure proposed for small producers by the Commission at the time the settlement agreement was executed.[13] *Small Producer Regulation,* Notice of Proposed Rulemaking, Docket No. R-393 (Sept. 9, 1974), 39 F.R. 33241 (Sept. 16, 1974). The 78¢ figure was exactly 150% of the then-existing national rate of 52¢ per Mcf at the time the settlement was executed. Thus, the incremental royalty is tied directly to Commission set rates[14] and not at all to intrastate rates. While it is true that the claim for royalty based on market value, which in turn may require a consideration of intrastate prices, provided the impetus for settlement (Comm.

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[11] Opinion No. 770-A (Nov. 5, 1976), *aff'd, The Second National Natural Gas Rate Cases,* 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied* ___ U.S. ___ (1978).

[12] A copy of such agreement, attached hereto as Appendix A, will be filed with the Commission and Pennzoil's petition for relief will be amended accordingly upon return of this cause to the Commission for disposition on the merits.

[13] Subsequently, the Commission adopted its rule permitting small producers to collect 130% of the national rates. *Small Producer Regulation,* Opinion No. 742, Docket No. R-393 (Aug. 28, 1975).

[14] Thus, the Commission is factually incorrect when it asserts that approval of Pennzoil's proposed rate relief would result in increases in Pennzoil's rates based on "unpredictable market fluctuations" (Comm. Br. 21-22). Pennzoil's rates would change *only* as the Commission changes its jurisdictional rates.

Br. 26), it is factually and logically incorrect for the Commission to assert that the settlement rate is therefore "tied to" or "based on" intrastate rates. The fact is that the settlement royalty increment gives absolutely no consideration to intrastate rates.

SUMMARY OF ARGUMENT

Section 4 of the Gas Act imposes on the Commission the responsibility to insure that the price received for jurisdictional gas sales is just and reasonable. This Court has repeatedly held that by this statutory mandate Congress vested in the Commission the wide discretion required for the Commission to carry out its broad responsibilities under the Gas Act. One of the basic rate making principles inherent in the Commission's authority is that it may take account of prudently incurred costs.

Consistent with that basic principle, this Court has specifically held the Commission has the authority to allow recovery of the specific costs involved in this case — market value royalty costs. *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974). The Commission believes this Court's decision in *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974), denied the Commission the very authority upheld in *Mobil*. The Commission also suggests the existence of this authority will somehow undermine its ability to carry out its responsibilities under the Gas Act.

The Commission has reached this erroneous result because it has misapplied *Texaco*. It has also failed to consider its full responsibilities under the Act. A proper reading of *Texaco* and full consideration of all of the Commission's responsibilities allow but one conclusion: as this Court held in *Mobil*, the Commission has the authority to allow recovery of the royalty costs involved in this case.

ARGUMENT

I.

THE COMMISSION SHOULD AND DOES HAVE AUTHORITY TO PERMIT NATURAL GAS COMPANIES TO COLLECT RATES WHICH INCLUDE INCREMENTAL ROYALTY COSTS ARISING FROM MARKET VALUE ROYALTY CLAIMS

The court of appeals held that the Commission has authority to permit a natural gas company to increase its rate to reflect an incremental royalty cost. Of course, Pennzoil agrees that any such proposed rate increase must be found on the merits to be just and reasonable in accordance with the statutory language in Section 4 of the Gas Act.[15] The Commission argues that regardless of the underlying merits of any particular case, it lacks authority to permit such a rate increase. The Commission makes two arguments: (1) possession of such authority would impair the Commission's ability to perform its statutory functions under the Gas Act (Comm. Br. 22-25) and (2) the authorities show the Commission lacks such authority (Comm. Br. 17-21, 26-36).

We will first demonstrate that possession of such authority enhances rather than detracts from the Commission's ability to carry out its responsibilities and then will show that the courts have clearly recognized the existence of such authority and that the Commission's reliance on *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974), is totally misplaced.

A. Lack of Authority Would Significantly Impair The Commission's Ability to Fulfill Its Responsibilities.

The authority which the Commission denies itself in this case derives from Section 4 of the Gas Act. 15 U.S.C. § 717c. Under Section 4, when a natural gas company (whether a

[15] Only the issue of authority is before the Court, and not whether Pennzoil's proposed rate is just and reasonable on the merits.

producer or a pipeline) proposes a rate increase, the Commission must determine whether the proposed rate is just and reasonable. Inherent in that standard rate-making authority is the requirement that prudently incurred costs be considered. *Smyth* v. *Ames,* 169 U.S. 466, 546-47 (1898).

The Commission argues that it should not have authority to permit prudently incurred incremental royalty costs based on market value claims to be collected if the total rate would exceed area or national levels because:

> 1. If the Commission has such authority it will be required "to review the circumstances of each case to determine whether particular royalty costs [resulting from market value royalty claims] for natural gas were or were not permissible for individualized reasons" (Comm. Br. 25) "and to determine, for example, the reasonableness of the producer's having incurred particular royalty costs" (Comm. Br. 14); and
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> 2. The Commission could not exclude such costs on the generic ground that they are *per se* improper (Comm. Br. 25).

Pennzoil agrees that those results would follow. Pennzoil believes it to be the Commission's obligation to hear and review individual requests for rate relief and to determine whether, on the merits, they should be granted.[16] The Commission's position could be restated more frankly as: The Commission should not have authority because if it does it will have to perform its duty of reviewing these rate proposals on their merits. We think that an excellent reason to conclude that the Commission has such authority.

[16] The Commission's argument that the court of appeals decision establishes a "presumption that such relief must be granted" (Comm. Br. 13) is absurd. All the decision stands for is the proposition that the Commission has authority to grant relief if a review on the merits demonstrates that such relief would meet the statutory tests.

While it is true that the Commission's responsibilities under the Gas Act are "'so framed as to afford *consumers* a complete, permanent and effective bond of protection from excessive rates and charges'" (Comm. Br. 18-19, emphasis in orig.), that is only a partial statement of the Commission's responsibilities. Congress' intention was "'that natural gas shall be sold in interstate commerce for resale . . . at the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest.'" *Atlantic Refining Co.* v. *Public Service Comm. of New York,* 360 U.S. 378, 388 (1959). Thus, the Commission's duty is two-fold, *i.e.,* assure reasonably low prices and assure adequate supply, and one inevitably has an effect on the other. *See, Placid Oil Co.* v. *FPC* 483 F.2d 880, 894-95 (5th Cir. 1973), *aff'd sub nom. Mobil Oil Corp* v. *FPC,* 417 U.S. 283 (1974). The Commission reached its erroneous conclusion because it only considered one-half of the purposes of the Gas Act and gave no thought to the adverse consequences which would flow from its position being sustained.

In order to accomplish these duties, the Commission has been instructed to set "just and reasonable" rates. Consistent with the purposes of the Act, this Court has held that "[a] price is thus just and reasonable within the meaning of §§4(a) and 5(a) not merely because it is 'somebody's idea of return on a "rate base,"' but because it results in satisfactory programs of exploration, development and production," *Permian Basin Area Rate Cases,* 390 U.S. 747, 796 (1968) (footnote omitted), and that the Commission is expected to "balanc[e] . . . the investor and the consumer interests." *FPC* v. *Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944).

We submit that the Commission cannot hope to achieve those goals unless it has authority to review on the merits rate proposals such as Pennzoil's, for such a review may indeed demonstrate that the proposed rate would be in accord with the purposes of the Act discussed above. If

the Commission lacks authority as it claims it would be unable to act to fulfill its responsibilities. But the Commission's authority has not heretofore been viewed as being so sparse as the Commission now claims. In its first area rate case under Section 4 of the Gas Act, this Court had a broader view of the Commission's authority. "This Court has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred... Surely the Commission's broad responsibilities therefore demand a generous construction of its authority," *Permian, supra* at 776 (citations and footnote omitted), and "We cannot, in these circumstances, conclude that Congress has given authority inadequate to achieve with reasonable effectiveness the purposes for which it has acted."[17] *Permian, supra* at 777.

Nor has Section 4 of the Gas Act been given a restricted interpretation. For example, the Commission is permitted to set rates within a "zone of reasonableness" and, within that zone, to "employ price functionally in order to achieve relevant regulatory purposes," and to "require differences in price for simultaneous sales of gas of identical quality, if it has permissibly found that such differences will effectively serve the regulatory purposes contemplated by Congress." *Permian, supra* at 797-98. As the Gas Act provides " 'for regulation along recognized and more or less standarized lines' and that there was 'nothing novel in its provisions,' " *FPC* v. *Hope Natural Gas Co.,* 320 U.S. 591, 616 (1944), costs of providing service are to be reviewed and permitted to be collected if reasonable and prudently incurred. As early as 1898 this Court affirmed that " . . . the sum required to meet operating expenses, are all matters for consideration and are to be given such weight as may be

[17] This Court also noted that the Commission "must be free, within the limitations imposed by pertinent constitutional and statutory commands, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests." *Permian* at 767.

just and right in each case." *Smyth* v. *Ames, supra* at 547.[18]

The only reference to royalty costs in the Gas Act is in Section 14(b), 15 U.S.C. § 717m(b):

> "(b) The Commission . . . may also, after hearing, determine the propriety and reasonableness of the inclusion in operating expenses, capital or surplus of all delay rentals or other forms of rental or compensation for unoperated lands and leases."

This Court has stated that Section 14(b):

> ". . . plainly [was] designed to aid the Commission in its rate-making functions. These provisions all suggest that when Congress designed this Act it was thinking in terms of the ingredients of a rate base, the deductions which might be made, and the additions which were contemplated." *Colorado Interstate Gas Co.* v. *FPC,* 324 U.S. 581, 602 (1945) (footnote omitted).

And referring directly to Section 14(b), this Court also said:

> "[The Commission] allowed, for example, delay rentals and exploration and development costs in operating expenses. . . . Moreover, if in light of experience they turn out to be inadequate for development of new sources of supply, the doors of the Commission are open for increased allowances. This is not an order for all time. The Act contains machinery for obtaining rate adjustments. § 4." *FPC* v. *Hope Natural Gas Co.,* 320 U.S. 591, 615 (1944) (footnote omitted).

These authorities indicate the Commission has authority to review royalty costs and permit their recovery in rates

[18] Royalty, being paid as a charge or fee for producing gas from the lessor's land, is certainly in the nature of an operating expense. Major treatises prior to passage of the Gas Act recognized that all items covering investment, operation and maintenance must be given full consideration in fixing rates. See 2 Pond, *Public Utilities* § 567, p. 1038 (4th ed. 1932).

if found on the merits to be just and reasonable. Congress evinced no intention to treat that cost component differently or to vest authority in the Commission to permit collection of a royalty component equal to but no higher than a fixed percentage of other components, the expenditures for which are not federally-regulated.[19] Had Congress wished to limit the Commission's authority to fulfill its purposes, Congress clearly could have done so.

If the Commission does have the responsibility to assure adequate producer income to assure in turn adequate gas supplies, the Commission's position here would undermine its ability to fulfill its responsibilities and would not, as the Commission argues, be in contravention of the basic scheme of the Act. Pennzoil's reading of the Act and cases is consistent in this regard with language employed by the court of appeals in *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976 (1972). In *Mobil* the court, in holding that royalty owners are not natural gas companies, considered the producer's complaint that the Commission order under review, while subjecting royalty owners to Commission jurisdiction, would nevertheless permit royalty owners to sue the producers for royalties in excess of Commission set rates. In that context, the court addressed the issue of authority:

> "More significantly, the FPC's jurisdiction over rates chargeable by a producer includes authority to determine the reasonableness of costs incurred, even though these are not subject to direct FPC control, and that establishes authority to review royalty payments, or

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[19] The Court of Appeals for the District of Columbia Circuit stated it slightly differently:

> "Expenses (using that term in its broad sense to include not only operating expenses but depreciation and taxes) are facts. They are to be ascertained, not created, by the regulatory authorities. If properly incurred, they must be allowed as part of the composition of the rates." *Mississippi River Fuel Corp.* v. *FPC*, 163 F.2d 433, 437 (D.C. Cir. 1947).

> drilling rig rentals, or any other element of the producer's cost of service." 463 F.2d at 263 (footnote omitted).[20]

It is frivolous to argue the Commission has the authority to determine the reasonableness of such costs but that if it finds them to be reasonable lacks authority to permit the producer to recoup them; under those circumstances it would be an idle act even to review such costs.

Reasoned analysis of the purposes of the Gas Act, actions necessary to fulfill those purposes and the broad authority accorded the Commission indicates the Commission is incorrect in asserting that possession of the authority it disclaims would undermine its ability to perform its duties.[21] Indeed, the opposite is true.

B. The Commission Possesses Authority To Permit Pennzoil To Collect Its Incremental Royalty Cost.

The Commission's disclaimer of authority in this case is bottomed almost solely on its reading of *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974), which the Commission reads as prohibiting any portions of a regulated rate from being "based

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[20] The Commission's argument (Comm. Br. 18, 30 n. 21) that it would not be *required* to permit flow-through of costs, *e.g.*, for platinum pipe misses the point although it is a correct statement, because it only means that if such costs were not prudently incurred the Commission may reject them. Of course the necessary corollary is that if those costs were prudently incurred the Commission has the *authority* to permit recoupment of those costs.

[21] The Commission's position is inconsistent with its actions on limited term certificates, 18 C.F.R. § 2.70, which were instituted and continued for the express purpose of assuring adequate supplies of gas. See Opinion No. 699-B, Docket No. R-389-B (Sept. 9, 1974) (mimeo at 1-2). The Commission, in order to fulfill its statutory responsibilities, issues limited term certificates at rates measured in substantial part as to justness and reasonableness by intrastate prices. See Opinion No. 699-B, *supra*, mimeo at 3-4; *South Louisiana Production Co.*, Docket No. CI76-208 (Jan. 26, 1976). The Commission's position in this case would seem to affect such actions adversely, so that the adverse effect on the Commission's ability to carry out its duties would extend beyond royalty cases.

on" unregulated gas prices (Comm. Br. 13, 19-21, 27-28) and its reading of *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974).[22] In addition to being contrary to the purposes of the Gas Act and its responsibilities under the Gas Act, the Commission's position is directly contrary to *Mobil* and is unsupported by *Texaco*.

In fact, the Commission's authority to allow recovery of the specific type of costs involved in this case has already been upheld by this Court. The market value royalty problem in the context of Commission regulated gas sales is not a new problem, nor is it unique to Pennzoil. The potential for the problem has been recognized for years, has been of industry-wide concern, and was first raised for judicial consideration in *Placid Oil Corp.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), *aff'd sub nom. Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974).

The *Placid* case was a review of the Commission's Opinion No. 598 which established a ceiling area rate for Southern Louisiana based on average costs. The royalty cost component of that rate was attacked on the grounds it failed to take account of the possibility of the precise type of royalty costs involved in this proceeding. The issue was

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[22] The Commission's arguments that (1) it may set area or national rates and "is not required" to grant relief when a producer's costs exceed the average (Comm. Br. 18) and (2) it is not required to allow recovery of a cost "if it is excessive or unreasonable" (Comm. Br. 18) are merely statements that the Commission is not *required* to do those acts and have nothing to do with the question of whether it has *authority* to act in this case. The same is true of its argument that it "may" refuse to allow rates resulting from indefinite pricing clauses (Comm. Br. 19).

Further, the Commission's statement that it does not grant relief unless costs exceed revenues (Comm. Br. 15), in addition to not addressing the issue of *authority*, is wrong. *See, e.g., American Petrofina Co. of Texas*, Docket Nos. RI75-17 and RI75-19 (March 3, 1975); *Pioneer Production Corp.*, Docket No. CI73-617 (Nov. 21, 1975) and cases cited therein at footnote 2; *Sohio Petroleum Co.*, Docket No. RI76-47 (Feb. 9, 1976); *Troporo Oil & Gas Co.*, Docket No. RI76-115 (May 10, 1976).

whether the royalty component was inadequate because it was based entirely on the ceiling rate while some producers faced the possibility of having to pay market value royalties based on prices in excess of the ceiling rate. The court of appeals held the royalty component to be adequate. The basis of that holding was not a lack of authority by the Commission to take account of such costs. Instead, the court determined that, because not all producers faced market value royalty costs, it was more appropriate to provide relief from such costs in individualized rather than industry-wide proceedings. Thus, the Court concluded:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief." 483 F.2d at 911.

This specific holding was reviewed in *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974). This Court quoted the above-quoted language from *Placid* with approval, affirmed the Court of Appeals determination that individualized relief is an available remedy for royalty costs based on prices in excess of ceiling rates, and held that "... an affected producer is entitled to seek individualized relief." 417 U.S. at 328. This holding is in accord with and is required by the undisputed rate-making principle that account must be taken of prudently incurred costs.

The Commission's suggestion that *Mobil* was merely a recognition of its general authority to grant relief in "some instances where actual costs are higher" but not a recognition that the Commission has the authority to grant relief for incremental royalty costs (Comm. Br. 15, 32) is wrong. *Mobil* was not decided in a vacuum. A reading of both *Placid* and *Mobil* makes it quite clear that this Court was speaking directly to the issue of whether relief may be granted for incremental royalty costs resulting from claims for increased royalty under "market value" leases. Whatever

its current position, the Commission itself in *Mobil* exhibited to this Court full confidence in its ability and authority to grant relief in a case like this. At page 62 of its brief to this Court in *Mobil* the Commission said:

> "Mobil argues . . . that the Commission improperly treated royalty payments as a fixed percentage of total costs, because some producers *may* be required to pay royalties on the basis of higher values. *The court of appeals correctly concluded that* the issue is hypothetical at this stage and that *if it becomes a reality producers may seek special relief from the Commission.*" (First emphasis in original; other emphasis added.)

Pennzoil is not aware of any case, nor has the Commission cited any case, in which a regulatory body either (1) asserted or even suggested it lacked authority to allow recovery of a prudently incurred cost or (2) was held to lack such authority. Yet, although its position flies squarely in the face both of this most basic rate making principle (recovery of prudent costs) and the clear language of *Mobil*, the Commission contends its unique position is compelled by *FPC* v. *Texaco Inc.*, 417 U.S. 380 (1974). The Commission has misapplied *Texaco*.

In *Texaco* this Court reviewed an attempt by the Commission to regulate the price for jurisdictional sales by small producers. The Commission's order attempted to discharge its responsibility indirectly by providing that small producers could receive their contract price (and therefore the small producer price was not directly regulated), but the purchaser would be authorized to recover the purchase cost in its own rates only if the price paid to the small producer did not exceed the unregulated market price. Thus the only standard to which the small producer was to be held, even indirectly, was market price.

This Court held the order invalid. The basis for that holding was the determination that in enacting the Gas Act

Congress necessarily rejected market price as a proper basis upon which sales subject to Commission jurisdiction should be set. In essence, as explained in *FPC* v. *Moss*, 424 U.S. 494, 502 (1976), the order deregulated a transaction (sales by small producers in interstate commerce for resale) Congress had committed to the Commission's jurisdiction.

The Commission's characterization of *Texaco* as being a case where the real issue was whether a component of a large producer's costs, *i.e.*, the cost of gas purchased from a small producer, could be based on intrastate levels (Comm. Br. 27-28) is both incorrect and misleading. In fact, *Texaco* was concerned with whether the *small producer* prices which were required to be regulated could be based solely on intrastate market levels. The essential difference between *Texaco* and this case is that the Commission is required to regulate prices received by small producers but it is not permitted to regulate payments which must be paid to royalty owners.[23]

We are not asking in this case that the Commission act in a manner that will result in deregulation of any transaction subject to its jurisdiction. The Commission does not have jurisdiction over the amount paid by producers to royalty owners. *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976 (1972). Therefore, unlike the case in *Texaco* where Congress had determined that small producer prices could not be based solely on market price, there has been no Congressional determination of the basis upon which royalties may be paid. To

[23] The Commission has retreated from its suggestion that the decision rejecting Commission jurisdiction over royalty owners be revisited (Comm. Br. 37, n. 22). In this connection, we dispute the Commission's assertion that the "bind" producers are in is caused by the lack of Commission jurisdiction over royalty owners and claims for royalty based on "market value" (Comm. Br. 32-33). To the contrary, that bind is caused by claims for "market value" royalty payments and the Commission's refusal to provide rate relief to producers.

the contrary, because royalty payments are not subject to Commission jurisdiction, and therefore are not a matter Congress intended that the Commission regulate, the Commission must have authority to allow their recovery as a cost component of the rates the Commission does regulate so long as they are reasonably and prudently incurred.

Furthermore, unlike the procedure the Commission attempted to utilize in the order reviewed in *Texaco,* Pennzoil does not suggest in this case that the Commission allow recovery of the costs involved either (1) solely because the costs are based on market value or (2) without a full inquiry into whether such costs were prudently incurred. First, as noted earlier, the royalty cost is not based on market value at all. Rather, it is tied to Commission ceiling prices and can only change as the Commission revises its prices. Second, Pennzoil does not suggest it should be allowed to recover the royalty cost without full review by the Commission. To the contrary, in accord with the *Texaco* mandate, we have requested the Commission to consider all of the relevant factors and fully expect the Commission to do so should the court of appeals' decision be affirmed. Consequently, unlike the procedure proposed by the Commission in *Texaco,* the Commission here "retains full control over its regulatory jurisdiction." *FPC* v. *Moss,* 424 U.S. 494, 502 n. 9 (1976). Pennzoil is merely seeking to have the Commission exercise its regulatory authority over Pennzoil's rates; Pennzoil is not seeking any deregulation.

Finally, we note that *Mobil* and *Texaco* were decided by this Court on the same day. We have extreme difficulty believing the Court would issue a decision denying the Commission authority to grant relief while at the same time issuing a decision assuring producers they could seek such relief from the Commission.

Two recent Commission orders serve to illustrate the distinctions between this case and *Texaco.* In *Columbia*

Gas Transmission Corp., Docket Nos. RP73-65 (PGA 75-5) (Aug. 1, 1977), the Commission considered, pursuant to the same Section 4 standard applicable to producer rates, the purchased gas cost component of an interstate pipeline's rates. The Commission had previously determined that some of the producer sales pursuant to which the gas in question had been acquired were non-jurisdictional.[24] Consequently, while the price the pipeline was to receive for the resale of the gas was regulated, the price the pipeline had paid for such gas was not regulated, was therefore based on the unregulated market value, and exceeded the ceiling price established by the Commission for producer sales subject to its jurisdiction.[25] Thus, the costs involved in *Columbia* (purchased gas costs) were identical in legal effect to the royalty costs in this case, *i.e.,* the amount paid by the natural gas company whose rates were being reviewed by the Commission was not regulated by the Commission. The Commission had no doubt of its authority to allow recovery of those costs. Rather, the Commission there recognized that because it had no authority to regulate the sales which resulted in the costs involved, the only question was whether the resulting costs were prudently incurred:

> "These purchased gas costs are not inherently different than other expenditures by Columbia which are clearly beyond the jurisdiction of this Commission. . . . The appropriate test to be applied to such expenses is that they be reasonable and prudent."[26]

The Commission reached the same result in *El Paso Natural Gas Co.,* Docket Nos. RP72-150, *et al.* (Feb. 16,

[24] *Columbia Gas Transmission Corp.,* Docket Nos. RP73-65 (PGA 75-5) (April 18, 1977).

[25] *Id.* at 1.

[26] *Columbia Gas Transmission Corp.,* Docket Nos. RP73-65 (PGA 75-5) (Aug. 1, 1977) at 9.

1977), a case involving facts almost identical to those in this case. In *El Paso,* the Commission, acting under Section 4 of the Gas Act, authorized El Paso (an interstate pipeline natural gas company) to recover in its rates increased overriding royalty costs resulting from overriding royalty payments based on prices in excess of the ceiling rate applicable to the vintage of gas involved. The instrument under which the overriding royalty payments are made by El Paso provides for payment based on the market value of the gas, just as the lease royalty provisions in this case do. The claims which resulted in the higher royalty payments were for royalties based on the unregulated intrastate market, just as in this case. The claims were settled, just as in this case. And, just as in this case, the settlement basis was an amount (1) tied to the highest Commission ceiling price and (2) in excess of the ceiling price applicable to the gas involved.

Apparently recognizing the obvious conflict between this case and *El Paso,* the Commission in *El Paso* attempted to distinguish the two. The primary basis set forth by the Commission as justifying the disparate treatment was that the Commission is free to use different methods in setting rates for pipelines (such as El Paso) than it uses in setting rates for independent producers (such as Pennzoil).

The question here is not whether the Commission *must* treat pipelines and producers the same with respect to market value royalty costs, but whether it is *authorized* to do so. And because the Commission's *authority* as to producer rates is conferred by the same statutory language as its authority as to pipeline rates, its *authority* is quite obviously precisely the same as to both. Consequently, while the ultimate treatment *may* be different, the Commission must at least consider on the merits whether the public interest requires that producers be allowed to recover market value royalty costs just as it requires that pipelines be allowed to recover such costs.[27]

The Commission also states that because Pennzoil is a producer relief is available only if Pennzoil demonstrates that its production costs exceed its revenues from the ceiling rates. Aside from that statement not addressing the question of authority, there is certainly no such requirement in the Gas Act. Consequently, any such requirement would have to result from an exercise of the Commission's authority and a determination that such a requirement is in the public interest under the facts of this case. Again, however, the Commission made no such determination. To the contrary, it determined that overall costs were not in issue, but instead the issue was whether the "*incremental royalty cost* is just and reasonable" (A. 260, emphasis in original). And on that question there can be no dispute. The price increase would generate absolutely no profit because it does nothing more than recover increased costs, and no one has claimed the costs to be recovered were other than prudently incurred. It is therefore not surprising that far from concluding that Pennzoil should not recover the market value royalty costs under the facts presented, the Commission concluded it was "sympathetic to the plight of the producers who face or may face litigation on the value of royalties" (A. 260). It is therefore clear the Commission did not deny relief because it deemed relief to be unjustified, but instead because, as the Commission stated, "we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to pipelines . . . ." (A. 261).

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[27] The Commission also asserts that because El Paso is a pipeline, there is no separately established ceiling rate applicable to El Paso's own production. As to new gas, this assertion is wrong. Section 2.66(c) of the Commission's rules and regulations provides that new gas produced by pipelines "shall be" priced at the generally applicable national rate for new gas. 18 C.F.R. § 2.66(c).

Finally, in discussing the prudence of El Paso's market value royalty costs, the Commission made reference to certain purported factual distinctions between this case and *El Paso*. Once again, however, because the Commission viewed its lack of authority as requiring rejection of Pennzoil's request without reference to the facts, it certainly made no finding that Pennzoil's market value royalty costs were imprudently incurred. As stated by the Commission:

> "Pennzoil also notes that no one has contended that the costs involved were improvidently occurred (sic). These considerations are not controlling." (A. 293).

Thus, *El Paso* certainly cannot be distinguished from this case on the grounds the costs in *El Paso* were prudent while those in this case were not.[28] The Commission's effort to distinguish *El Paso* from this case serves only to reveal that there is no distinction. The two cases are the same. The results reached must be the same.

The results in both *Columbia* and *El Paso* are consistent with *Texaco* and are correct. The result reached by the Commission in this case is incorrect because the Commission misapplied *Texaco*. *Texaco* simply holds that the Commission may not deem a price for gas *sold subject to Commission jurisdiction* just and reasonable based solely on the unregulated market price of gas because to do so would be tantamount to deregulating a transaction Congress mandated the Commission regulate. When, as here, the issue is the propriety of recovery of costs resulting from a *non-jurisdictional transaction,* no question of deregulation can possibly arise. Rather, whether the transaction resulting in the costs is non-jurisdictional because it involves a sale of a commodity not subject to the Commission's jurisdiction (such as drill pipe), or because it involves a sale of gas in a market over which the Commission has no authority (as in *Columbia*), or because it involves a royalty payment instead of a gas sale (as in *El Paso* and this case), the result must be the same. The Commission has *authority* to grant relief if justified on the merits.[29] *Texaco* requires nothing different.

[28] Furthermore, the Commission did not even accurately characterize the Pennzoil facts. The Commission noted that El Paso's overriding royalty settlement costs were tied to Commission ceiling rates and were not based solely on intrastate market prices. We have repeatedly informed the Commission that the costs in our case are tied to Commission ceiling rates and are not based on intrastate market prices. The Commission's response has always been (A. 261) and is now (Comm. Br. at 26-27) that the "impetus of the settlement is the market value of the royalties." While that certainly does not transform a cost not based on market value into one based on market value, we simply point out that the "impetus" for the settlement in *El Paso* was precisely the same as that in this case: claims for royalty payments based on market value. The costs in this case are therefore no more based on market value than were those in *El Paso*.

II.

THE ABANDONMENT ISSUE SHOULD BE REMANDED TO THE COMMISSION FOR FULL CONSIDERATION ON THE MERITS

In seeking certiorari, the Commission framed the issue as whether it has authority to grant abandonment of the royalty share of Pennzoil's gas (Pet. 3). Presumably certiorari was granted on that issue. However, in its brief the Commission framed and briefed a wholly different issue, *i.e.*, whether the Commission properly denied abandonment on the merits (Comm. Br. 2, 37-40).

We presume the Commission has dropped any pretense of lack of authority. Section 7(b) of the Act clearly authorized the Commission to grant abandonment if "the present or future public convenience or necessity permit. . . ." 15

[29] As stated by the Commission in *Columbia*, "[t]he appropriate test to be applied to such expenses is that they be reasonable and prudent." *Columbia Gas Transmission Corp.*, Docket Nos. RP73-65, (PGA 75-5) (Aug. 1, 1977) at 9.

U.S.C. § 717f(b). And the Commission did not claim lack of authority in denying abandonment but rested its decision on other grounds (A. 261-63). Whether the Commission lacked authority was never raised before the Commission or before the court of appeals and has not been briefed to this Court by the Commission. To the extent that issue could properly be before this Court, the answer is obvious: The Commission has the authority.

The somewhat confused status of the abandonment issue can be traced to the rather unique treatment the Commission accorded Pennzoil's abandonment request. Pennzoil had suggested to the Commission that if for some reason it did not wish to grant Pennzoil's rate proposal substantially the same beneficial objectives could be achieved by granting abandonment of the royalty share of the gas. One objective which could be achieved by either alternative was to avoid the risk of loss of the entire gas supply if the lessors prevailed in terminating the lease.

Having refused to discuss rate relief on the merits because of its feeling that it lacked authority, the Commission then turned to abandonment. After making the conclusory assertion that "the public convenience and necessity, present or future, is not served by granting an abandonment authorization that would likely result in the subject gas becoming diverted from the interstate market to the intrastate market" (A. 262),[30] the Commission then addressed only one of the several reasons advanced in support of abandonment, *i.e.,* the risk of loss of all the gas if the leases were terminated. Relying on its recently issued *Southland*[31] decision, the Commission found that the interstate market would retain the gas even if the leases were terminated and, with that risk eliminated, abandonment of the royalty gas was unnecessary (A. 262-63).

[30] The statutory test, of course, is not whether the public interest will be *served* by abandonment but whether the present or future public convenience or necessity *permit* abandonment. 15 U.S.C. § 717f(b).

[31] *El Paso Natural Gas Co.,* 54 FPC 145 (1975), *aff'd sub nom. California* v. *Southland Royalty Co.,* U.S. (1978).

The court of appeals reversed and remanded, basing its action on its recent reversal of the Commission's *Southland* decision. *Southland Royalty Co.* v. *FPC,* 543 F.2d 1134 (5th Cir. 1976), *rev'd sub nom. California* v. *Southland Royalty Co.,* U.S. (1978).

The Commission now argues that its abandonment decision should be affirmed on the merits because its *Southland* decision has been upheld. Pennzoil believes the appropriate course of action would be for the matter to be remanded so the Commission can view the matter fully on the merits, including all the arguments and evidence. Pennzoil has not yet had the full consideration of this issue to which it is entitled because of the cursory treatment given it by the Commission. For example, as Pennzoil pointed out to the Commission (A. 221-22; 276), even if the gas remained in the interstate market upon lease termination, the price would increase substantially. If the lease were terminated, Williams would become the seller. Williams qualifies as a "small producer" and would be entitled to receive "small producer" prices. *See Jicarella Apache Tribe* v. *FERC,* 578 F.2d 289 (9th Cir. 1978). The small producer prices which Williams would receive are about thirty percent higher than the prices Pennzoil, as a large producer, may collect.[32] Consequently, the possibility of lease termination presents a very serious risk (higher prices for *all* of the gas) the avoidance of which may justify abandonment of a fraction of the gas. Yet the Commission has given no attention at all to this consideration.

[32] *Small Producer Regulation,* Opinion No. 742, Docket No. R-393 (Aug. 28, 1975). The price small producers may collect for "new" gas is the same as large producers may collect, but there is no new gas involved in this case.

Furthermore, when the Commission rejected the abandonment request, it believed it had no authority to grant price relief. Should Pennzoil prevail on the rate issue, the Commission may on remand determine that the abandonment alternative is preferable to the price increase alternative. The Commission should not be denied the latitude to resolve the problem with either alternative.

As for the Commission's argument, we do not believe the fact that without abandonment authorization the gas will remain in interstate commerce (a truism in all abandonment cases) is adequate reason for the Commission to avoid its responsibility of determining whether the full evidence shows that "the present or future public convenience or necessity permit abandonment." 15 U.S.C. § 717f(b). For these reasons, this issue should be remanded.

CONCLUSION

The judgment of the court of appeals should be affirmed.

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CERTIFICATE OF SERVICE

I hereby certify that I have served this brief on all parties on October 5, 1978, in accordance with the rules.

....
Jeron Stevens

APPENDIX A

October 24, 1977

Pennzoil Producing Company
Pennzoil Place
P. O. Box 2967
Houston, Texas 77001

Attention: Mr. A. Duncan Gray, Jr.

Shell Oil Company
P. O. Box 60193
New Orleans, Louisiana 70160

Attention: Mr. Alvin G. Gibson

Gentlemen:

Section I of the settlement agreement between Pennzoil and Shell ("lessees") and Williams, Inc., *et al.*, ("lessors") dated June 18, 1975, sets forth two procedures, namely the so-called "royalty tracker" procedure and the so-called "abandonment" procedure. The royalty tracker generally provides, under current circumstances, for a royalty to be paid on an amount equal to 150% of the "base alternative rate" plus certain adjustments, as the term "base alternative rate" is defined and used in Section I.A. of the agreement.

Section II.A. of the agreement provides that the settlement agreement will be implemented if the FPC authorizes either of the procedures described in Section I. and if the FPC authorizes any other procedure acceptable to all parties to the agreement.

Considering all current circumstances, and in an effort to achieve prompt and final resolution of the matter, lessors have determined that the following is an acceptable alternative procedure under Section II:

1. For the period from the effective date of an FPC order authorizing a royalty tracker in an amount equal to the royalties which would be paid under this alternative procedure through July 26, 1976, the amount of royalty payments shall be determined in the manner set forth in the Settlement Agreement, and

2. Commencing July 27, 1976, the amount of royalty payments shall be determined in the manner set forth in the Settlement Agreement except that "100%" shall be substituted for "150%" in Section I.A. of the Settlement Agreement.

In the event the FPC authorizes a royalty tracker in an amount equal to the royalty payments that would be made under the alternative procedure described above, lessors will amend the Settlement Agreement as necessary to incorporate such alternative procedure therein.

In view of all of the circumstances, lessors believe the alternative procedure set forth above is a reasonable settlement basis and authorize Pennzoil and Shell to propose such alternative procedure to the FPC.

Yours very truly,
WILLIAMS, INC.

FRANK B. WILLIAMS
President

FBW: fw